



Governor Dayton's FY 2014-15 Budget Focuses on Tax Reform, Financial Stability and Investments

Governor Mark Dayton laid out his plan for Minnesota's future in the budget proposals he released earlier this year. His budget seeks to share the responsibility for funding public services more equitably, put the state on firm financial footing and invest in the building blocks of shared economic success.

The budget seeks to reach those goals in part through a tax reform package designed to raise more revenues to fund the state's priorities and make the tax system fairer. The major components of the tax plan are a new state income tax bracket for the highest-income Minnesotans, higher taxes on tobacco products and ending some exemptions from the corporate franchise tax.

The budget's new investments focus on education, including addressing Minnesota's deep achievement gaps, through additional funding for schools, special education, all-day kindergarten and quality early childhood learning opportunities. The budget invests in Minnesota's workforce through funding for financial aid and economic development. And it builds on work already done earlier in this legislative session to ensure more Minnesotans have affordable health care.

Governor Dayton originally presented his budget proposal in January, and released a supplemental budget proposal in mid-March to reflect the February forecast's new state budget projections. This analysis focuses on the major general fund changes in the Governor's current budget proposal.

Limited Resources Go a Long Way in Health and Human Services

Many Minnesotans have seen the value of public health and human services at some point in their lives, whether it's child care assistance that enabled a friend to keep her job, nursing home care for an elderly parent, or affordable health insurance for a cousin with a chronic illness. These and other essential services improve the health and stability of Minnesota families throughout the state.

Governor Dayton's budget proposal increases general fund resources for health and human services by \$210 million over forecasted spending for the FY 2014-15 biennium, a 9 percent increase from FY 2012-13. Despite the wide scope of this area of the state budget, the Governor manages to stretch limited new dollars quite far. The initiatives in his budget will improve the lives of thousands of Minnesotans and help the state provide services more efficiently.

The Governor's budget allows more than 200,000 low-income Minnesotans to access more affordable and comprehensive health insurance through Medical Assistance by increasing eligibility and making it easier to enroll. In mid-February, Governor Dayton signed a bill taking the first step to expand eligibility for parents, young adults and adults without children.¹ The Governor's supplemental budget includes an additional \$316 million in FY 2014-15 general fund spending to provide better access to health insurance for children and pregnant women, as well as removing other barriers to enrollment.

For the past 20 years, MinnesotaCare has enabled hundreds of thousands of working Minnesotans to purchase affordable health insurance for themselves and their families. The Governor's budget seeks to preserve MinnesotaCare for most participants, taking advantage of federal funding to continue health insurance coverage for parents, young adults and adults without children with incomes between 138 percent and 200 percent of the federal poverty line (between \$15,856 and \$22,980 for an individual).

In order to meet the need for more trained health care professionals, the Governor proposes increasing funding for Medical Education Research Costs (MERC) by \$13 million in the FY 2014-15 biennium. This will fund grants to health care providers who train medical students.

The Governor's proposal will allow thousands of children to access better mental health care by investing in more school-linked mental health services, improving the coordination of care for children with complex conditions and helping family members learn skills so they can support their child's treatment. The Governor invests in mental health services for all ages by funding additional mobile mental health teams to respond to crises, helping Minnesotans with mental health issues make the transition from institutional care back into the community, and improving access to mental health services by increasing some provider reimbursement rates and expanding the range of services covered.

The state's Reform 2020 plan restructures services for the elderly and Minnesotans with disabilities to ensure the "right services at the right time." The Governor's proposal implements some of these recommendations, including helping individuals receive care in their homes rather than in institutions, providing more intensive services for children with autism, and supporting housing stability for people with chronic conditions. The Governor's supplemental budget also eliminates a 1.67 percent cut in payment rates to long-term care providers scheduled to be in effect from July to December 2013.

In order to address intergenerational poverty, the Governor proposes start-up funding for a home visiting initiative to improve graduation rates among teen parents and ensure the healthy development of their children. The Governor also proposes to change how income is counted when determining eligibility for the Minnesota Family Investment Program (MFIP) in order to reward parents who are working toward self-sufficiency.

The Governor's budget also includes increased funding to improve payment rates to high-quality child care providers, improving access to this opportunity for more than 2,000 children. Unfortunately, the Governor's budget does not include funds to help the more than 6,000 working families currently on the waiting list for assistance for affordable child care.

Some of the changes in the Governor's budget are aimed at improving the quality and efficiency of existing services. For example, the Governor's budget modernizes Minnesota's human services technology system to provide services more efficiently. He also takes advantage of the state's bargaining power, finding savings through strategies like negotiating for lower prices and rebates on state purchases, like higher rebates for diabetic test strips, which save the state more than \$500,000 in FY 2014-15.

The Governor's supplemental budget added \$500,000 for funding for FAIM, or Family Assets for Independence in Minnesota, which matches savings by low-income participants for post-secondary education, purchasing a home, or starting a business. The Governor also proposes \$5 million in FY 2014-15 for youth homelessness prevention.

Unfortunately, the need for services after a decade of cuts can't be reversed in just one budget. For example, although the Governor's budget proposes funding for Emergency Medical Assistance to provide cancer and dialysis treatment for qualifying non-citizens, it is just a small step in rebuilding an adequate health care safety net.

Significant Investments in E-12 Education Build a Stronger Future

A strong education is crucial to a person's economic success. Making sure all of Minnesota's children get a solid education is also key to the state's future success. Minnesota has long made education a top priority for state investment, but significant achievement gaps between white Minnesotans and Minnesotans of color remain to be addressed.

Governor Dayton invests \$355 million in additional resources for E-12 education in the FY 2014-15 biennium, including initiatives focused on ensuring all children, including children of color and those with greater needs, can succeed.

One of the most significant proposals in the Governor's budget updates the primary funding formula for school districts and increases general education funding by \$113 million in FY 2014-15, or \$52 per pupil. This new formula bases equity revenues on a school district's actual revenues from referendums rather than state averages, and increases flexibility for schools in using funding.

The Governor also recommends boosting special education funding by 13 percent in FY 2014-15 and replacing the current special education formula with a new one in FY 2015 that would allocate more funds to districts with students having greater needs.

Minnesota has one of the worst achievement gaps between white students and students of color in the nation. Governor Dayton's budget supports increased funding for initiatives to enable all students to succeed, including:

- An additional \$44 million per biennium for the Early Learning Scholarship program, which provides scholarships for high-needs children ages three to five to participate in early learning opportunities, including high-quality child care and early childhood programs.
- Funding for optional all-day kindergarten so that more children are prepared for success in school. This funding is expected to increase participation in free all-day kindergarten from 49 percent in FY 2012 to 85 percent in FY 2015.
- Extended funding for districts with English Language Learner students ages five to seven to improve their achievement levels.

In his original budget proposal, the Governor committed resources to reverse the remaining education funding shift in the FY 2016-17 biennium. However, the supplemental budget withdraws this recommendation in favor of following current law, which uses any positive balances in the general fund to repay the remaining \$808 million in shifts.

Increased Resources Make Higher Education More Affordable

Minnesota will need more workers with degrees and credentials over the next decade to keep the state's economy competitive. Projections indicate that by 2018, 70 percent of jobs in the state will require a post-secondary education, so it is imperative to invest in our students and workers. Governor Dayton reverses the trend of cuts to higher education by increasing funding by \$263 million in FY 2014-15, a 10 percent increase from FY 2012-13.

Governor Dayton's budget works to make college more affordable by increasing financial aid through the State Grant program by \$80 million. Grants will increase by up to \$1,400 to more accurately reflect higher education costs, and about 5,000 students will become eligible for financial aid. The Governor also enhances funding for an American Indian scholarship program to enable the 500 students currently on the waiting list to receive up to \$4,000 in financial aid for undergraduate students and \$6,000 for graduate students.

The Governor's budget increases funding for the Minnesota State Colleges and Universities (MnSCU) system by \$80 million in FY 2014-15 to support skill-building programs and retain high-quality faculty and staff. It provides funding to the University of Minnesota to freeze tuition for undergraduate students for two academic years. The Governor also proposes a loan forgiveness program for University of Minnesota students who become health care professionals working in under-served parts of the state, and provides \$36 million to support research and development in key areas of innovation.

However, even with these investments in higher education, state funding would remain barely above levels from 12 years ago – despite enrollment growth of more than 38,000 students from 2002 to 2011.

Economic Development Funding Focuses on Job Creation and Housing

For the state's economy to grow, Minnesota needs continued investments in a strong and stable workforce. Employees need education, specialized training and stable housing to succeed at their jobs. The Governor's economic development budget includes \$70 million to make investments in job creation and housing.

Governor Dayton proposes substantial investments in loans and grants to Minnesota businesses through the Minnesota Investment Fund and the Minnesota Job Creation Fund. These funds will collectively receive \$55 million in additional funding over the biennium with the goal of creating 12,500 to 15,000 new jobs in the state.

Stable and affordable housing is important for attracting and keeping a high-quality workforce. The Governor's budget includes one-time funding for several housing initiatives:

- \$10 million for the Housing and Job Growth Initiative, aimed at building affordable housing in areas with job growth but not enough housing for workers.
- \$2 million for rental assistance to encourage greater housing stability for students who move frequently.
- \$1 million to help ex-offenders find housing as they return to the workforce.

These investments in housing to promote economic development are in FY 2014-15 only; the Governor's budget does not continue the funding in FY 2016-17.

Other Investments Will Assist Low-Income Families and Veterans

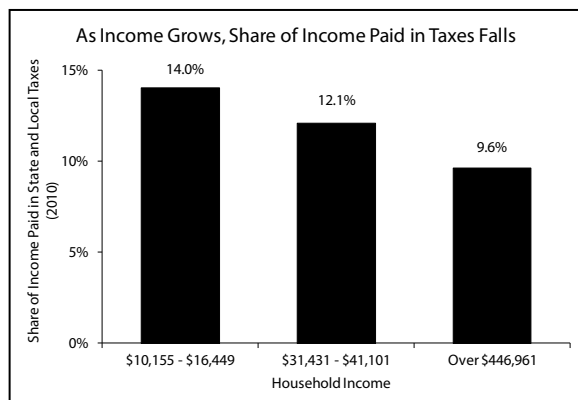
In other areas of the budget, the Governor recommends small investments to ensure that Minnesotans have adequate legal and tax assistance:

- \$1 million for civil legal services that will help several hundred low-income families get legal assistance to help resolve housing, credit, family matters and other civil issues.
- \$400,000 for taxpayer assistance grants to help meet the current demand for free tax preparation services for Minnesotans who are low-income, elderly, disabled or limited English speakers.
- \$3 million for Crime Victim Assistance grants to restore funding that was cut in the FY 2010-11 biennium.

The Governor's budget also ensures that Minnesota veterans have access to better education and health benefits. He proposes an expansion of the GI bill, helping bring unemployed veterans back into the workforce by allowing those who served before September 11, 2001, to receive education and training benefits. The Governor also invests \$5 million to update the Minnesota Department of Veterans Affairs' technology infrastructure and improve access to health care for veterans.

The Governor's Proposal Seeks to Make Tax System More Adequate and Fair

Tax reform is long overdue in Minnesota. Our tax system has two serious problems. First, it does not raise enough revenues to meet the state's needs, contributing to a cycle of frequent budget deficits. And second, the responsibility for funding public services is not shared fairly. In fact, as household income grows, the share of income paid in taxes falls. The wealthiest one percent of Minnesotans (those with household incomes over \$446,961) pays 9.6 percent of their incomes in total state and local taxes. This is significantly less than the 12.1 percent paid by a middle-income household making \$31,431 to \$41,101.²



The Governor's tax reform plan seeks to make the state's tax system less regressive and narrow that gap. It also puts the state on more stable financial footing, raising revenue to address the state's \$627 million budget shortfall and make investments in the state's future success.

The major components of the tax reform plan are a new income tax bracket on the highest-income Minnesotans, ending some existing corporate franchise tax preferences and an increase in tobacco taxes.

Governor Dayton's tax plan would create a new income tax bracket on the highest-income Minnesotans, which would raise \$1.1 billion in the FY 2014-15 biennium. This "fourth tier" would apply a 9.85 percent tax rate to taxable income above \$250,000 for married filing joint filers, above \$200,000 for heads of households and above \$150,000 for single filers. Only the 2.1 percent of Minnesotans with the highest incomes would pay any additional income tax under this proposal.

This component of the tax reform plan is perhaps the most important in closing the gap between the share of income that the highest-income Minnesotans pay in state and local taxes and what average Minnesotans pay. The experiences of other states with similar proposals find them to have little impact on the number of wealthy individuals in their states.³

The proposed fourth tier also has no impact on most Minnesotans with "pass-through" income on their individual income taxes – a group often described as "small business owners." Only 6 percent of tax returns with positive pass-through income would pay more under the proposed fourth tier.⁴

Another important strategy for making the tax system less regressive is ensuring that lower-income households aren't paying too high a share of their incomes in taxes. The Minnesota Working Family Credit – the state's version of the federal Earned Income Tax Credit – is a very effective tool for tax fairness. The Governor's supplemental budget would update the Working Family Credit to reflect recent federal improvements.

The Governor's budget also would require more part-year residents to pay income taxes on a portion of their income, raising \$30 million in FY 2014-15. Currently, part-year residents who maintain a home in Minnesota need to be in the state for 183 days or more to be subject to the income tax. The Governor's budget would reduce that threshold to 60 days.

Over time, Minnesota has come to rely less on state taxes and more on local property taxes, which are based on home value and not as closely linked to someone's ability to pay. This is one contributing factor to the rising regressivity of the tax system.

Cuts in state funding to cities and counties over the years have created pressure on local property taxes. The Governor seeks to begin to reverse this trend through increasing funding for Local Government Aid to cities by \$80 million and County Program Aid by \$40 million in FY 2015.

The Governor's budget also includes \$18 million in FY 2015 in improvements to the Renters' Credit, which provides a property tax refund to low- and moderate-income renters whose property taxes are high in relation to their incomes. The Renters' Credit is effective in reducing the regressivity of rental property taxes, but it has been eroded in recent years, particularly by a 13 percent cut passed in 2011.⁵ More than 310,000 Minnesota households are expected to benefit from an average \$57 increase in their Renters' Credits under the Governor's budget. This is an important provision to ensure that low- and moderate-income Minnesotans don't pay too high a share of their incomes in property taxes.

Governor Dayton's tax plan would raise \$317 million through increased tobacco taxes, primarily an increase of 94 cents per pack of cigarettes. Tobacco taxes are the state's most regressive taxes, but the Governor has said he supports an increase because it would reduce state health care costs in the long term by providing a powerful deterrent against youth smoking and a motivation for smokers to quit.

The Governor's proposal would end several tax preferences in the corporate franchise tax, the largest of which are the Foreign Royalty subtraction, which exempts royalty payments a multinational corporation receives from its foreign subsidiaries, and Foreign Operating Corporations (FOCs), which provides a tax benefit for parts of multinational corporations that are incorporated in the U.S. but receive substantial income from foreign sources. It would also adjust minimum fees paid by corporations, partnerships and S-corps. In total, these provisions raise \$316 million in FY 2014-15.

The Governor's proposal would move toward a more level playing field among retailers by requiring some remote sellers to collect sales taxes from Minnesota residents, just as retailers physically located in the state do. The "affiliate nexus" provision would raise \$10 million in FY 2014-15 by requiring remote retailers who sell their products to Minnesotans through referrals from businesses with a physical presence in Minnesota to collect the sales tax. Currently, sales taxes are due on these purchases, but the responsibility for remitting that tax falls to the customer.

The Governor's budget also raises \$15 million from a higher rate on motor vehicle rental taxes to fund an increase for the state's tourism bureau; and raises local funds for transit through a 0.25 percent local sales tax increase in the seven-county metro area.

The tax plan is the part of the budget that changed most between its original introduction and the release of the supplemental budget. In the supplemental budget, the Governor took out a sweeping sales tax reform proposal. That proposal would have reduced the state's sales tax rate from 6.875 percent to 5.5 percent, and would have applied this lower rate to some currently exempt goods and a number of services purchased by consumers and businesses.

Newly taxed items would have included items of clothing that cost more than \$100; digital goods; consumer services such as auto and other repair services, personal services such as haircuts, spa treatments and legal services; and services purchased by businesses, such as management consulting services, custom computer services and advertising.

When he removed the provision to tax business services, there no longer was enough revenue to cover a number of tax cut provisions in the original budget, and these were removed in the supplemental budget also. These included:

- A property tax rebate of up to \$500 to all Minnesota homeowners.
- Lowering the state's corporate franchise tax rate from 9.8 percent to 8.4 percent.
- Lowering the state property tax paid by business and cabins.
- Providing businesses with a sales tax exemption on capital equipment at the time of purchase, replacing a cumbersome refund process.

Three strategies are important in crafting a tax plan that seeks to make the tax system more adequate and fair:

1. An income tax increase focused on those with the highest incomes should be a significant component.
2. Increases in regressive taxes should not be too large.
3. Policies such as refundable tax credits should be used to offset some of the increases in taxes paid by low- and moderate-income Minnesotans.

Governor Dayton's tax package uses all three of these strategies as he seeks to raise the revenues needed to address the budget deficit and make critical new investments, and to share the responsibility for funding public services more evenly across income groups.

Governor's Budget Provides a Good Framework for Legislature to Follow

Governor Dayton's FY 2014-15 budget takes important first steps to reinvest in our state and restore financial stability after years of cuts and budget gimmicks. It now falls to the Minnesota Legislature to craft legislation to put the next two-year budget into place. Legislators should make three goals their priorities: raise adequate revenues to resolve the budget deficit, make the tax system less regressive, and invest in our future.

By Caitlin Biegler, Nan Madden and Christina Wessel

¹ House File 9.

² Minnesota Department of Revenue, [2013 Minnesota Tax Incidence Study](#), March 2013. The data are for taxes paid in 2010, the most current data available. See also Minnesota Budget Project, [The Facts Still Speak: It's Time to Reform Minnesota's Tax System](#), March 2013.

³ Center on Budget and Policy Priorities, [Tax Flight Is a Myth: Higher State Taxes Bring More Revenue, Not More Migration](#), August 2011. See Minnesota Budget Project, [Tax Increases Don't Prompt High-Income Households To Move Out of State](#), April 2013.

⁴ Minnesota Department of Revenue. These are income tax claims with positive income from sole proprietor, S-corp, or partnership income. See Minnesota Budget Project, ['Fourth Tier' Would Have Little Impact on Small Businesses](#), April 2013.

⁵ See Minnesota Budget Project, [Renters' Credit Maintained in 2011, Cut in 2012](#), August 2011.